Budget Tidbits... just the facts

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Pensions in Peril

State Actuary's report portrays system in jeopardy

A recent report shows the financial condition of Washington's public pensions to be in a perilous state, requiring dramatic increases in taxpayer contributions over the next decade, while the oldest plans for teachers and public employees are at risk of running out of assets prematurely.

I. 'Extraordinary Efforts' Required to Address Health of Retirement Systems[1]

Every two years, the State Actuary is charged with reporting on the financial condition of the state retirement systems. This year's report, which will be presented to the Pension Funding Council on September 30th, is alarming.

A. *Plans are 'At-Risk'*

The oldest retirement systems for teachers and public employees (Teachers' Retirement System Plan 1 and Public Employees Retirement Systems Plan 1) have long had unfunded liabilities, tracing back to underfunding in the 1970s and 1980s. But the state actuary now concludes -- "as a result of (recent) delayed and suspended contributions, increased benefits, and the large investment losses of the last two fiscal years" -- TRS 1 & PERS 1 are now at risk of running out of assets before all benefits get paid.[2]

PERS 1 is now expected to drop to a funded status of 47%, while TRS 1 will drop to 51%.[3] According to the actuary, any funding status below 60% is considered "at-risk".

While the more recent plans (TRS plans 2/3 and PERS plans 2/3) are in better shape, they too are "now at risk of becoming unhealthy".[4] Their funding status is expected to drop from approximately 120% down to 88%.[5] At that level the plans are still considered healthy, but the key assumption underlying that conclusion -- and a questionable one -- is that all required contributions are made in the future. As will be seen below, the level of contributions needed are dramatically higher over the next 10-20 years. If contributions are not made, these plans too may fall into the "unhealthy" or "at-risk" category.

<u>To reiterate, even if all actuarial recommended contributions are made in the future, the state's oldest plans are "at risk" of running out of assets, and the newer plans will only remain in "healthy" status if such payments are made, regardless of magnitude.</u>

B. *Contributions Need to Rise 'Well Above Maximum Levels Ever Collected'*[6]

Government -- via the taxpayers -- contributes each biennium to the funding of the public retirement systems. **Contributions are expected to triple in the next six years.**

Projected Employer Contributions *(Dollars in Millions)*		
	General Fund State	Total Employer (State & Local)
2009-11	$661	$1,740
2011-13	$1,357	$3,429
2013-15	$1,888	$4,766
2015-17	$2,321	$5,866
2017-19	$2,731	$6,923
2019-21	$3,008	$7,583

Source: Transmittal Letter -- 2009 Report to Pension Funding Council (p. 2, 8/31/09)

This is not a short term problem, either. Expressed as a percentage of employees' salaries, the rates employers will be paying are expected to rise above the maximum levels ever collected next biennium and remain there for the next fifteen years.

By analogy, imagine the state and local government contribution rate as an adjustable rate mortgage. That mortgage rate is expected to almost triple in the near future and remain near that level not for a short time, but rather for the majority of the life of the mortgage.

C. *Actuary's Conclusion*

Even under a return to exceptional market returns, the State Actuary concludes that biennial employer contributions will still <u>nearly triple</u> over the next six years.[7] And rates would remain above historical maximums through at least the next decade.

II. Much Blame Lies on Malfeasance of Legislature Over Past Decade

The recent precipitous decline in the stock market led to the blossoming of this report, but the roots can be traced back to a series of lamentable, short-sighted decisions made by the Legislature and governors over the past decade. Here is a timeline:

- *1998* -- Legislature adopts gain-sharing benefit to "share" benefits of high-stock market returns with employees in form of enhanced retirement benefits.[8] Believed at the time of passage to cost no money, the benefit was later found to cost multiple billions. Bill contained "reservation" clause in which legislature retained right to terminate benefit.

- 2001 -- Raised level of investment returns assumed from 7.5% a year to 8%.[9] This resulted in employers having to make lower contributions, as it was expected that higher stock market returns could make up the difference.
  -- Pushed back full funding date of TRS & PERS plan 1 unfunded liabilities from December 2016 to June 2024 to save money in short-term.[10]

- *2003* -- Skipped actuarially-recommended unfunded liability payment to TRS & PERS plan 1 for the 2003-05 biennium.[11]

- *2005* -- Skipped actuarially-recommended unfunded liability payment to TRS & PERS plan 1 for the 2005-07 biennium.
  -- Made aware by the actuary of the costs of gain-sharing, the Legislature delays decision, choosing to neither repeal nor fund the benefit.[12]

- *2006* -- Despite sizable surplus, Legislature fails to 'catch-up' on skipped payments, choosing only to phase in 2007-09 payment over subsequent three years.[13]
  -- Once again, inaction on gain-sharing.

- *2007* -- Despite largest surplus in state history, ignored actuary recommendation to increase funding needed due to longer life spans of employees.
  -- Ignored actuary recommendation to lower investment return assumption to 7.75%, which would have increased employer funding to pension system by $3 billion over 25 years. Recommendation was supported by state's chief economist, and State Investment Board's own models.[14]
  -- Repealed gain-sharing benefit, but replaced it with a new benefit that cost 2/3rd as much. The new benefit consisted of a lower retirement age for plans 2 and 3, and a retirement cost-of-living adjustment for plan 1. Amazingly, new benefit applied to broader class of employees than gain-sharing.[15] Unlike gain-sharing, no "reservation" right was attached, meaning the benefit is permanent and may not be taken away by future legislatures.
  -- Effective date of gain-sharing repeal was set to take place after the projected January 2008 distribution to employees of a share of the

previous four years' “extraordinary” stock-market returns. Employers are still paying past gain-sharing distributions today.[16]

- *2009* -- Pushed back the payoff date of the TRS/PERS 1 unfunded liability from 2024 to an unspecified date in future based off a rolling ten-year average.
  -- Made only 36% of actuarial-recommended plan 1 unfunded liability payment for biennium.
  -- Suspended minimum contribution rates required by law.
  -- Ignored actuary recommendation for increased funding needed due to longer life spans of employees, delaying implementation to 2011-13.
  -- Lowered “salary” growth assumption below actuarial-recommendation.[17]

- **Notably, it looks like the pattern will continue again.** The actuary's long-term economic assumptions contained in this report recommend a lowering of the long-term investment return assumption from 8% to 7.5%. OFM's budget director has already sent out indicators that he will push the Pension Funding Council to reject that recommendation, despite the fact that it is in line with the State Investment Board's investment model.[18]

III. Where Do We Go From Here?

The state actuary makes clear that business as usual will not be enough to preserve Washington's pension plans in the future, stating:

"[A]ddressing the financial condition and the long-term economic assumptions of the retirement systems will require extraordinary efforts . . . [and] [w]ithout a plan to manage these risks, the retirement systems as we know them may not be sustainable."[19]

It is an astonishing statement that every legislator, member of the news media, and interested citizens should become familiar with and demand their elected officials live up to.

In developing a plan to manage these risks, several questions arise:

1. Are the plans sustainable over the long run?

2. Can government/taxpayers afford projected levels of future contributions? This is a question pertinent to both state and local governments.

3. Can the Legislature be trusted to change its behavior in the future, or will it always pass more benefits in good times and shirk on those commitments in bad times?

What is clear is that, at least for current employees and retirees, government must fulfill its commitment. Employees have a contractual right to the pension benefit in place at the time they were hired. And, while it may be unnecessarily costly now due to past underfunding, it is a legal commitment the legislature (and taxpayers) are constitutionally and ethically bound to keep.

Bottom Line

After years of lamentable decisions, Washington's public pension plans are in a perilous state, requiring taxpayer contributions in the future of an unprecedented level.

Will the Legislature step up and provide the "extraordinary efforts" needed, or will it continue to ignore the actuary's recommendations as it has so often done the past decade?

1. Office of State Actuary, *Transmittal Letter -- 2009 Report to Pension Funding Council (p. 2, 8/31/09).*
2. Id., p. 3.
3. Id., p. 4.
4. Id., p. 3.
5. Id., p. 4.
6. Id.
7. Id., p. 3.
8. ESHB 2491 (1998).
9. ESSB 6167 (2001).
10. Id.
11. EHB 2254 (2003).
12. See Senate Operating Budget Summary, p. 3. (4/24/05)
13. See Senate Operating Budget Summary, p. 1. (3/8/06). See also ESSB 6896 (2006).
14. See Zarelli Tidbit, *Pension Peril -- Disregarding Professional Advice (10/22/07).*
15. EHB 2391 (2007).
16. Office of State Actuary, *2009 Report on Financial Condition, p. 4.*
17. SB 6161 (2009).
18. Office of State Actuary, *2009 Economic Experience Study, p. 12 and Appendix H.* See OFM Director Victor Moore's comments at September meeting of Select Committee on Pension Policy.
19. Office of State Actuary, *Transmittal Letter -- 2009 Report to Pension Funding Council, p. 2.*